GAO.13:GGD 82-77

BY THE U.S. GENERAL ACCOUNTING OFFICE

Report To The Commissioner, Internal Revenue Service

Special IRS Examination Procedures Are Needed For Certain Returns Containing International Tax Issues

24

Tax returns filed by U.S. citizens abroad and nonresident aliens contain special international tax issues. IRS thus has found it necessary to centralize the related examination responsibility in its Foreign Operations District in Washington, D.C. To accommodate the needs of certain taxpayers, however, IRS frequently transfers their returns to other district offices which do not specialize in international tax issues. These districts find it difficult to effectively examine such returns.

To improve the examinations, GAO recommends that IRS (1) train selected auditors in international tax issues, (2) make pertinent reference documents available, (3) use special procedures to assign these returns, and (4) develop and make effective use of information reports which summarize work already completed by the Foreign Operations District. IRS concurred with most of GAO's findings, conclusions, and recommendations.

GAO/GGD-82-77
AUGUST 27, 1982

Request for copies of GAO reports should be sent to:

U.S. General Accounting Office
Document Handling and Information
Services Facility
P.O. Box 6015
Gaithersburg, Md. 20760

Telephone (202) 275-6241

The first five copies of individual reports are free of charge. Additional copies of bound audit reports are $3.25 each. Additional copies of unbound report (i.e., letter reports) and most other publications are $1.00 each. There will be a 25% discount on all orders for 100 or more copies mailed to a single address. Sales orders must be prepaid on a cash, check, or money order basis. Check should be made out to the "Superintendent of Documents".

BEST DOCUMENT AVAILABLE

UNITED STATES GENERAL ACCOUNTING OFFICE
WASHINGTON, D.C. 20548

GENERAL GOVERNMENT
DIVISION

B-207784

The Honorable Roscoe L. Egger, Jr.
Commissioner of Internal Revenue
Department of the Treasury

Dear Mr. Egger:

For the past several months, we have been reviewing the Internal Revenue Service's (IRS') Office Audit Program for returns containing international tax issues. Under this program, IRS selects and examines certain tax returns filed by U.S. citizens residing overseas and nonresident aliens.

The responsibility for conducting examinations of returns containing international tax issues has been centralized in IRS' Foreign Operations District Office. 1/ At the request of a taxpayer, however, the Foreign Operations District will transfer a return to a domestic district 2/ to carry out and/or complete an examination. Typically, taxpayers make such requests because they have returned to the United States since filing the return at issue and/or because their representatives are located near a domestic district office. Besides examining returns transferred by the Foreign Operations District, domestic districts also examine, on a selective basis, returns which aliens must file before departing the country. Both returns transferred to domestic districts and departing alien returns contain issues relating to foreign income exclusions and deductions not contained in typical U.S. resident taxpayer returns.

1/Before May 7, 1982, the Foreign Operations District was referred to as the Office of International Operations.

2/Within the context of this report, the term "domestic district" refers to any of the 59 other IRS district offices. These offices deal primarily with U.S. resident taxpayer returns. Although the Foreign Operations District is headquartered in Washington, D.C., it deals primarily with taxpayers who reside in foreign countries and nonresident aliens who must file U.S. tax returns.

Our work at IRS' Manhattan District Office indicates that the efficiency and effectiveness of domestic district examinations of tax returns containing international issues can be improved. Because domestic district tax auditors are unfamiliar with international tax issues, they understandably feel uncomfortable when examining such returns. This situation is aggravated by current IRS procedures which do not afford these returns special treatment. Currently, IRS handles the returns in accordance with procedures which it has found most suitable for U.S. resident taxpayer returns. As a result, domestic district tax auditors have little opportunity to develop expertise in international issues. Furthermore, IRS has little assurance that domestic district examinations are as effective and efficient as they could be.

We brought these matters to the attention of IRS officials in February 1982 and suggested several ways to improve IRS' approach. Among other things, we suggested that IRS train selected domestic district tax auditors in international issues. We also suggested that IRS modify its methods for handling returns containing international issues in domestic district offices. Although our work was limited in scope, the IRS officials concurred with our findings and conclusions and informed us that corrective actions would be initiated. Additionally, by letter dated July 8, 1982, the Acting Commissioner of Internal Revenue generally agreed with our findings, conclusions, and recommendations. The latter comments have been incorporated, as appropriate, in the report and included in full in the appendix.

OBJECTIVE, SCOPE, AND METHODOLOGY

The objective of our audit was to evaluate how efficiently and effectively domestic district offices conduct examinations of certain tax returns containing international issues. In particular, we focused on Office Audit Program examinations of (1) returns transferred to domestic districts and (2) returns filed by departing aliens. We conducted our work at the Foreign Operations District Office in Washington, D.C., and the Manhattan District Office in New York, New York. We developed statistics on returns transferred by the Foreign Operations District in 1980; reviewed Foreign Operations and Manhattan District procedures for handling, assigning, and examining such returns; and reviewed returns transferred to and being examined by the Manhattan District. We also reviewed the Manhattan District's processing of departing alien returns and discussed the nature and complexity of problems involved in examining returns containing international issues with Foreign Operations and Manhattan District officials, group managers, and tax auditors. In addition, we spoke to Foreign Operations and Manhattan District training personnel and reviewed tax auditor training course materials. This work was performed in accordance with generally accepted Government auditing standards.

DOMESTIC DISTRICT OFFICES EXAMINE CERTAIN RETURNS CONTAINING INTERNATIONAL TAX ISSUES

Because special tax laws and regulations apply to U.S. citizens residing abroad and nonresident aliens with U.S. source income, primary responsibility for examining returns filed by these taxpayers has been centralized in IRS' Foreign Operations District Office. Nevertheless, IRS' 59 domestic district offices sometimes are called on to examine certain tax returns containing international issues. These returns differ substantially from typical U.S. resident returns in that they are governed by a variety of special rules concerning exclusions, deductions, and credits.

Examinations of returns containing international issues are transferred to domestic districts at the request of individual taxpayers. Although taxpayers may have a variety of reasons for requesting transfers of examinations to domestic districts, they normally do so because (1) they have, since filing the return at issue, returned to the United States as a resident and/or (2) their representatives are located near a domestic district office.

In fiscal year 1980, the Foreign Operations District examined 12,220 tax returns. In addition, during calendar year 1980, the Foreign Operations District transferred 1,135 returns to domestic districts for examination. As the following table shows, most returns were widely dispersed among the district offices. However, five district offices received 486, or about 43 percent, of the 1,135 transferred returns.

Returns Transferred
By The Foreign Operations District
In Calendar Year 1980

District office	Number of returns transferred	Percent
Los Angeles	135	11.9
Manhattan	130	11.4
San Francisco	106	9.3
Austin	59	5.2
Jacksonville	56	4.9
Total	486	42.7
All other domestic district offices	649	57.3
Total	1,135	100.0

In addition to examining returns transferred by the Foreign Operations District, domestic districts are responsible for assuring that aliens leaving the United States pay any income taxes they owe before they depart. To obtain a certificate of tax compliance, an alien must file a form 1040C with a district office. If the return meets certain criteria, the district office may select it for and conduct an immediate examination. IRS believes that it has a better chance of collecting additional taxes while the alien is in the United States than it would after the taxpayer's departure. However, on-the-spot examinations do not preclude subsequent examinations of the same returns and/or related full-year returns aliens may file at a later date. In any case, once a return has been accepted, the district issues a certificate, commonly known as a sailing permit, to the alien. Statistics on the number of departing alien returns examined by domestic districts were not available.

Both returns transferred to domestic districts and departing alien returns contain special tax issues not contained in typical resident taxpayer returns. U.S. citizens residing abroad and nonresident aliens are subject to special tax laws and regulations which affect the amount of U.S. income tax owed. Depending on the tax year of the return, U.S. citizens residing abroad may be eligible for foreign-earned income exclusions or deductions for foreign living costs, such as housing and schooling for dependents, not permitted U.S. resident taxpayers. Frequent tax law changes further complicate these exclusions and deductions.

Nonresident aliens, unlike U.S. citizens abroad and resident taxpayers, are taxed only on income earned from sources within the United States. Income connected to a U.S. trade or business is taxed at the graduated rates that apply to U.S. citizens and resident aliens. However, there are limitations on personal exemptions and deductions which can be taken before computing taxable income. Income not connected to a U.S. trade or business, such as interest and capital gains, is taxed at a flat 30-percent rate. Adjustments and deductions are not permitted against this income. As a further complication, the aforementioned general rules may differ on a country-by-country basis depending on whether one of the United States' 40 income tax treaties with foreign governments must be taken into account.

Thus, returns transferred to domestic districts and returns filed by departing aliens contain a variety of special issues which tax auditors do not normally encounter when examining U.S. resident taxpayer returns. Even so, domestic districts do not afford the returns any special treatment.

BEST DOCUMENT AVAILABLE

RETURNS CONTAINING INTERNATIONAL ISSUES ARE NOT AFFORDED SPECIAL TREATMENT

Domestic district office examinations of individual tax returns containing international issues could be more effective and efficient. Although these returns contain special tax issues, they generally are handled in the same manner as U.S. resident tax returns and are not afforded special treatment. The lack of special treatment can reduce the effectiveness and timeliness of examinations. In particular, we identified the following three problem areas.

--Tax auditors who are unfamiliar with the laws and regulations governing tax returns containing international issues find it difficult to examine the returns and thus are not sure how accurate their adjustments are.

--Return assignment procedures do not afford tax auditors either the opportunity to gain experience in examining returns containing international issues or the time to prepare for examinations before scheduled interviews with taxpayers.

--The Foreign Operations District does not always summarize the examination work it carried out before transferring a return to a domestic district office and does not always highlight the name and telephone number of the tax auditor who initiated the examination. As a result, prior work may be duplicated and examination progress may be slowed.

We discussed our findings with various officials responsible for IRS' examination activities. The officials agreed that domestic district examinations of returns containing international tax issues could be improved.

Domestic district tax auditors are not familiar with international issues

Domestic district tax auditors sometimes are called on to examine returns containing international issues. The auditors, however, receive little international tax training and thus are unfamiliar with certain issues on such returns. In contrast, Foreign Operations District tax auditors receive both classroom and on-the-job training in this area. Without adequate training, domestic district tax auditors understandably find it difficult to examine tax returns of this type. The fact that domestic district tax auditors lack training in international issues may be known to taxpayers and/or tax practitioners. This in turn may result in IRS receiving a greater number of transfer requests than otherwise might be expected.

Although domestic district tax auditors receive both classroom and on-the-job training, that training is directed primarily at issues involved in U.S. resident taxpayer returns. With the exception of the foreign tax credit, which affects some U.S. residents, domestic district tax auditors receive little training in international issues. In contrast, Foreign Operations District tax auditors receive 2 weeks of intensive classroom training in international tax laws and in regulations and methods used to examine international returns. Further, that training is supplemented by 4 weeks of closely supervised on-the-job training.

Because domestic district tax auditors are not afforded similar training, the effectiveness of their examinations of returns containing international issues may be somewhat limited. In this regard, several Manhattan District tax auditors and a group manager told us that such returns are difficult to examine. The auditors told us that they are unfamiliar with applicable tax laws and regulations and sometimes find it difficult to determine how adjustments to one item on a return affect other items on the return, and, ultimately, the amount of tax owed. They further stated that, as a result, they are not sure how accurate their examinations are.

Besides lacking training in international tax issues, domestic district tax auditors also lack adequate sources of reference and guidance. For example, the Manhattan District lacks both a copy of the Foreign Operations District international examination training manual and an effective consultation mechanism. This district does have an informal procedure whereby certain revenue agents, who specialize in the international aspects of corporate returns, are made available to tax auditors for consultation 2 days a week. Tax auditors told us, however, that the agents do not provide prompt assistance because they too need time to research the individual income tax laws and regulations. As a result, to obtain prompt assistance, the auditors tend to consult peers or group managers who, like the auditors, lack training in these issues.

Thus, domestic district tax auditors face a difficult task in carrying out examinations of tax returns containing international issues. And, our discussions with Manhattan District tax auditors indicate that taxpayers and/or tax practitioners may be well aware of the difficulty of that task. In this regard, several Manhattan District tax auditors expressed the concern that taxpayers may request transfers in hopes of getting more favorable examination results from domestic districts than might be available from the Foreign Operations District. Our analysis of examination cases transferred to the Manhattan District lends some possible credence to that theory.

During December 1981, Manhattan District tax auditors provided us with examination case files on 18 returns transferred by the Foreign Operations District. We reviewed the 18 examinations and found that 9, or 50 percent, had been substantially completed by the Foreign Operations District before being transferred. 1/ Specifically, in the nine cases, the Foreign Operations District had corresponded with the taxpayers and gone as far as proposing tax adjustments in examination reports. In six of the nine cases, the Foreign Operations District had also received supplemental information from the taxpayer and had written a second examination report. Still, the affected taxpayers, after receiving Foreign Operations District reports, had requested transfers of their examinations to the Manhattan District Office.

Neither we nor IRS know why these taxpayers were so motivated. They may simply have wanted the opportunity to discuss the returns with an IRS representative face-to-face. Nonetheless, the fact that the transfers were requested after receipt of proposed tax adjustments, rather than when the examination process began, lends some credence to the possibility that some taxpayers may have been seeking more favorable results.

In commenting on a draft of this report, however, IRS stated that it had reviewed 52 case files which were in the process of being transferred to domestic districts. IRS found that each case file contained a taxpayer letter citing specific reasons for the transfer. IRS, however, did not elaborate on the contents of those letters and did not go as far as to say that the letters provide sufficient insight into taxpayers' motivations.

Instead, IRS noted that it is not unusual for a taxpayer to request a transfer so that unresolved issues can be discussed face-to-face. IRS further stated that it is agency policy to provide taxpayers with such an opportunity. Finally, IRS said that its analysis of the 52 case files indicated that taxpayers who requested transfers did not receive more favorable examination results.

We agree that, when feasible, IRS should provide taxpayers the opportunity to discuss examination-related issues face-to-face. In so doing, however, IRS must ensure that its auditors, regardless of their geographic location, have the training needed to make consistent decisions. In this regard, IRS observed that its review of a sample of 52 transferred examination cases did not indicate that taxpayers were receiving more favorable examination results from domestic districts. We did not review IRS' sample

---

1/The nine cases involved five taxpayers.

since that sample was taken after we stopped our audit work. Thus, we do not know what specific data IRS used to reach this observation. We were subsequently informed by IRS personnel, however, that the domestic district examinations of IRS' sample cases had not been completed at the time of IRS' review. Thus, it would not appear that IRS could have based its observation on a comparison of adjustments proposed by the Foreign Operations District versus those proposed by domestic districts. Regardless, however, IRS said that it plans to provide better training to certain tax auditors in domestic districts (see pp. 12 and 13 and the appendix). This will help to better ensure that taxpayers receive equitable treatment regardless of the geographic location in which an examination is conducted.

In any case, domestic district tax auditors' current unfamiliarity with international tax issues is cause for concern. The possibility that taxpayers and/or tax practitioners may currently be taking advantage of that situation also is cause for concern. And, existing IRS procedures for handling such returns do little to alleviate those concerns.

Current IRS return assignment procedures do not take into account the need for special treatment of returns transferred to domestic districts

Domestic district office procedures for assigning tax returns transferred by the Foreign Operations District have not been modified to compensate for tax auditors' unfamiliarity with such returns. Assignments are made on a random basis and tax auditors have little time to prepare for examinations. As a result, tax auditors, who have little on-the-job training in international tax issues, must either conduct on-the-spot examinations or cancel scheduled interviews with taxpayers or their representatives. Neither alternative promotes effective tax administration.

Domestic district tax auditors are familiar with a wide variety of the issues involved in tax returns filed by U.S. residents. Therefore, IRS has found it unnecessary to have individual tax auditors within specific groups specialize in certain resident tax return issues. Instead, examination assignments are made primarily on a workload basis without regard to which tax auditor will work on a specific case. While IRS has found this case assignment approach useful for U.S. resident taxpayer returns, the approach also is used to assign returns transferred by the Foreign Operations District. The utility of this case assignment approach for returns containing international tax issues seems questionable for one main reason--it affords no individual tax auditor or small group of tax auditors the opportunity to

develop expertise in examining such returns. As a result, tax auditors generally are called on to conduct examinations of returns containing issues with which they have had little experience.

Moreover, like the situation with resident tax returns, tax auditors generally receive such examination case files shortly before scheduled meetings with taxpayers and/or their representatives. In such situations, the auditors have a choice--they can either conduct an on-the-spot examination of the tax return to the extent feasible or they can cancel the meeting. In the former instance, tax auditors cannot prepare for the examination by researching the issues or thoroughly reviewing examination work performed by the Foreign Operations District. As a result, IRS has little assurance that these examinations are conducted in an effective manner. In the latter instance, taxpayers and/or their representatives may be inconvenienced by the canceled meeting. Such inconveniences do little to promote a positive image of IRS among affected taxpayers and their representatives.

In commenting on a draft of this report, IRS said that the Manhattan District had previously established guidelines to assign returns containing international tax issues to specific tax auditors, so that the auditors might gain experience with these returns. IRS also said that these returns should have been assigned as "precontact analysis" cases. Precontact analysis cases are those which require advance examination planning or which involve issues requiring research or analysis prior to contacting the taxpayer. IRS said, however, that these guidelines were not being followed by the Manhattan District at the time of our review.

Thus, we found that current IRS return assignment procedures do not take into account the need for special treatment of returns transferred to domestic districts. IRS needs to remedy this situation by revising its return assignment procedures. It also needs to take action on a related matter--the need for the Foreign Operations District to enclose useful summaries in case files it transfers.

Case files transferred by the Foreign Operations District do not contain useful summaries

Many case files transferred to domestic districts involve examinations initiated and at least partially completed by the Foreign Operations District. In such instances, a tax auditor trained in international issues has spent some time analyzing the return and evaluating certain examination issues. The work carried out by the Foreign Operations District should in theory facilitate followup work carried out by domestic district tax

auditors. However, Foreign Operations District tax auditors do not always summarize the work they have performed before sending returns to domestic districts. Moreover, they do not always specifically identify themselves as contact points for resolving questions domestic district tax auditors may have about work performed before the return was transferred.

Current IRS guidelines require that Foreign Operations District tax auditors summarize the work they have performed before transferring a return to a domestic district. However, the guidelines do not provide a specific format for tax auditors to follow nor do they require tax auditors to record their names and telephone numbers in the summaries. Furthermore, the guidelines do not require that group managers ensure that a summary has been prepared before approving a transfer. Our analysis of 18 examination case files transferred to the Manhattan District disclosed that none contained a summary of prior work done by the Foreign Operations District. Yet, 9 of the 18 cases involved essentially completed examinations in that one or more examination reports had been prepared by the Foreign Operations District.

When Foreign Operations District tax auditors do not prepare summaries, domestic district tax auditors must review all the paperwork included in each case file to determine the status of an examination. This can be a time-consuming task. Yet, as previously discussed, domestic district tax auditors have little time to prepare for these examinations. Also, because domestic district tax auditors are not familiar with international issues, there is no assurance that they fully understand the work done by the Foreign Operations District. Moreover, Manhattan District auditors told us that when the name of a contact was not highlighted in the file, they generally did not telephone the Foreign Operations District when questions arose concerning prior examination work.

If the Foreign Operations District were to develop and make use of a standard summary report for returns it transfers, domestic district tax auditors could conduct more effective and more timely examinations. Also, a domestic district tax auditor would be less likely to duplicate work already performed by the Foreign Operations District.

- - - -

Although our findings and conclusions were based on a limited scope review, we brought them to IRS' attention early in the review in accordance with our normal practices. Specifically, on February 4, 1982, we met with the Acting Deputy Assistant Commissioner for Compliance, the Director of IRS' Examination Division,

BEST DOCUMENT AVAILABLE

and the Acting Director of IRS' Office of International Operations. The IRS officials indicated that the Manhattan District adequately represents how domestic districts handle tax returns transferred by the Foreign Operations District, at least from an Office Audit Program standpoint. They further stated that the scope of our review was sufficient to demonstrate that several problems exist. They said that they would not wait for our report to be issued to take actions to improve domestic district examinations of tax returns containing international issues.

Furthermore, by letter dated July 8, 1982, the Acting Commissioner of Internal Revenue agreed with our observation that Manhattan District tax auditors find it difficult to examine tax returns containing international issues. However, the Acting Commissioner noted that the problems we identified in that district may not be the same throughout the nation. Still, IRS' planned actions in response to our recommendations should help assure consistent nationwide handling of tax returns containing international issues.

CONCLUSIONS

Domestic district office examinations of returns containing international issues are not as effective and efficient as they could be. Although such returns contain special issues, they are generally handled in the same manner as U.S. resident tax returns and are not afforded special treatment. This lack of special treatment can reduce the effectiveness and timeliness of examinations.

Some returns containing international issues are examined by domestic district tax auditors who have not been provided sufficient training or guidance. Moreover, domestic district return assignment practices do not provide tax auditors either the opportunity to become familiar with the issues through experience or the time to research the laws and regulations before scheduled interviews with taxpayers. Further, the Foreign Operations District does not always (1) adequately summarize work performed before transferring returns to domestic districts or (2) specify the name and telephone number of an appropriate person for a domestic district tax auditor to call should questions arise concerning prior examination work.

RECOMMENDATIONS

To improve domestic district office examinations of individual income tax returns containing international issues, we recommend that the Commissioner of Internal Revenue:

--Provide a limited number of tax auditors in selected domestic district offices with training in these issues.

This should be done in those district offices which have a case workload sufficient to justify expenditures on such training. An alternative would involve considering the feasibility, from a cost-benefit standpoint, of detailing Foreign Operations District tax auditors to certain domestic districts for the purpose of conducting or completing examinations of returns transferred by the Foreign Operations District. For example, affected domestic districts could accumulate these returns for a period of time until a sufficient caseload inventory developed. Then, the Foreign Operations District could detail a tax auditor to the domestic district to work the cases. The latter approach was suggested as a possibility by IRS officials during our February 1982 meeting.

--Provide each IRS domestic district office with Foreign Operations District training manuals and other appropriate reference documents for use by tax auditors conducting examinations of returns containing international issues.

--Revise return assignment procedures to provide tax auditors the experience and preparation time needed to examine returns transferred by the Foreign Operations District. Specifically, returns should be assigned to selected tax auditors designated to examine returns containing international issues. Also, returns should be assigned in advance of scheduled taxpayer interviews to allow tax auditors the time to research issues and to review examination work already performed.

--Require that the Foreign Operations District develop and make effective use of standard summary information reports for returns transferred to domestic district offices. The reports should clearly explain the international tax issues involved, the work done, and the conclusions reached, and they should describe any special circumstances concerning the transferred return. Also, the summary report should contain the name and telephone number of an appropriate Foreign Operations District contact. Finally, the Commissioner should require that Foreign Operations District group managers ensure that case files contain summaries before the files are transferred to domestic district offices.

AGENCY COMMENTS AND OUR EVALUATION

In a letter dated July 8, 1982, the Acting Commissioner of Internal Revenue generally agreed with our findings, conclusions, and recommendations. The Acting Commissioner said that IRS would:

BEST DOCUMENT AVAILABLE

--Provide international tax training to a limited number of tax auditors in selected domestic districts. In this regard, an IRS task force will soon begin preparing materials for a training course to be given in the first quarter of fiscal year 1983.

--Provide necessary reference materials to the tax auditors who participate in the planned international tax training course.

--Advise domestic district offices to assign transferred Foreign Operations District cases to tax auditors with experience in examining returns containing international tax issues.

--Send a memorandum to IRS regions receiving Foreign Operations District cases emphasizing the need for precontact analysis on these returns. This will provide domestic tax auditors the time needed to research and analyze cases before scheduling appointments with taxpayers.

IRS' proposed actions are generally responsive to our recommendations. We do, however, have some remaining concerns. First, as noted above, IRS plans to provide international tax reference materials to tax auditors who participate in IRS' planned training course. Clearly, this is a step in the right direction. However, during recent discussions with IRS personnel, we were told that IRS neither plans to provide training nor to distribute reference materials to tax auditors in each domestic district office. We agree that training should be limited to those districts in which there is a sufficient caseload to justify such expenditures. On the other hand, we do not agree with IRS' decision to limit distribution of reference materials to the same districts. In our view, each IRS district that receives Foreign Operations District examination cases ought to have the necessary reference materials. Otherwise, IRS' planned nationwide emphasis on precontact analysis for transferred cases will do little to alleviate the problems tax auditors encounter when examining tax returns containing international tax issues. Clearly, providing tax auditors with the time needed to research international issues would not prove very productive unless the auditors have reference materials to carry out that research.

Second, IRS did not agree with our recommendation that it require the Foreign Operations District to develop and make effective use of standard summary information reports. IRS said that it reviewed 52 cases and found that (1) each case contained a Foreign Operations District tax auditor's name and telephone number, (2) practically all cases contained summaries in one form or another and many contained instructions to the receiving

BEST DOCUMENT AVAILABLE

auditor on how to follow through with the adjustment, and (3) each case contained a transfer form which had been approved by the group manager. Therefore, IRS concluded that summaries were being used and that group managers were ensuring that case files contained summaries.

We too found that the names and telephone numbers of Foreign Operations District tax auditors often were included in the case files. However, we noted that the names and numbers could not always be found on similar documents and that searching through each file for that information was time-consuming.

Similarly, IRS stated that it found summaries "in one form or another" in each of its 52 sample cases. In contrast, none of the 18 case files we reviewed contained a summary. There are several possible reasons why our results differed markedly from IRS' findings. We began our work in December 1981 and brought our findings to IRS' attention in February 1982, whereas IRS subsequently carried out its review of sample cases in April 1982. It is thus conceivable that corrective action may have been initiated during the time interval between the two separate reviews. Alternatively, we and IRS may have used different criteria in evaluating whether a particular document constituted a summary. In this regard, we noted that, in its comments, IRS did not state that the summaries it found contained all of the basic information called for in our recommendation.

We also noted that IRS has since issued additional guidance on this matter to Foreign Operations District group managers. Specifically, in a June 10, 1982, memorandum, a Foreign Operations District Branch Chief instructed group managers to:

> "* * *ensure that the auditors' names and telephone numbers are in all transferred cases. In addition, ensure that their workpapers provide an adequate audit trail and clearly reflect the audit work that has been completed."

These instructions are in keeping with the intent of our recommendation and, if followed, should improve case file contents and should facilitate follow-on work on the part of domestic district tax auditors. However, determining the quality and adequacy of an "audit trail" can be a very subjective process. Group managers' views on such matters may differ greatly. Thus, we still believe that IRS could alleviate many potential problems by developing and using a standard summary information report.

Also, use of standard reports would enable IRS to take action on a closely related matter--the need to more specifically fix the responsibility for assuring preparation and inclusion of summaries in case files. In its comments, IRS pointed out that a

BEST DOCUMENT AVAILABLE

Foreign Operations District group manager's approval on a case transfer form does not mean that the case file has been reviewed for completeness. In our view, group managers ought to be specifically charged with the responsibility for ensuring that case files are complete before being transferred. And, if IRS developed and used standard summary information reports, the group manager's case file review would be facilitated.

In sum, we remain convinced that the Foreign Operations District should develop and use standard summary information reports and that group managers should ensure that transferred case files contain these summaries. By implementing this recommendation, IRS would provide domestic district tax auditors with ready reference documents which would help them to accurately complete examinations.

- - - -

As you know, Section 236 of the Legislative Reorganization Act of 1970 requires the head of a Federal agency to submit a written statement on actions taken on our recommendations to the Senate Committee on Governmental Affairs and the House Committee on Government Operations not later than 60 days after the date of this report, and to the House and Senate Committees on Appropriations with the agency's first request for appropriations made more than 60 days after the date of this report.

Copies of this report are being sent to the Secretary of the Treasury; the Director, Office of Management and Budget; and other interested parties.

We appreciate the assistance provided us by IRS staff members in carrying out this review. We look forward to working with you on other tax administration issues in the future.

Sincerely yours,

W. J. Anderson

William J. Anderson
Director

BEST DOCUMENT AVAILABLE

COMMISSIONER OF INTERNAL REVENUE

Washington, DC 20224

July 8, 1982

Mr. William J. Anderson
Director, General Government Division
United States General Accounting Office
Washington, DC 20548

Dear Mr. Anderson:

Thank you for the opportunity to review a draft of your proposed report entitled "Special Procedures Would Improve IRS Examinations of Certain Returns Containing International Tax Issues." Our specific comments have been provided in two enclosures. Enclosure I addresses the text of the report, and Enclosure II comments on your recommendations.

Generally, we agree with the findings in your report as well as its recommendations. However, in the text it was brought out on several occasions that cases transferred from the Foreign Operations District to the Manhattan District lacked sufficient summaries to assist the new tax auditor. Our general findings in this area did not result in the same conclusion since we found that practically all cases reviewed contained more than adequate summaries, and aided the new auditor in continuing the examination.

The Service fully agrees that additional training is needed by district office tax auditors (other than Foreign Operations District) to effectively examine tax returns with international tax issues. To initiate action on this matter, the Service is convening a task force during July 1982 to develop such a training course for tax auditors; our goal for the first session is the first quarter of FY 83.

The Service will also advise district offices to use tax auditors with experience in examining international issues to ensure that a knowledgeable and effective audit of tax returns is conducted.

With kind regards,

Sincerely,

Enclosures

Acting Commissioner

BEST DOCUMENT AVAILABLE

Enclosure I

IRS COMMENTS ON GAO DRAFT REPORT "SPECIAL PROCEDURES WOULD IMPROVE IRS EXAMINATIONS OF CERTAIN RETURNS CONTAINING INTERNATIONAL TAX ISSUES"

Comments on Text

PAGE 5, PARAGRAPH 1

-- Tax auditors who are unfamiliar with the laws and regulations governing tax returns containing international issues find it difficult to examine the returns and feel unsure of the accuracy of adjustments made.

Comment:

We agree with this statement only as it pertains to the tax auditors in Manhattan District. Since no other districts were visited either by GAO or National Office this problem may not be the same throughout the U.S.

PAGE 5, PARAGRAPH 1

-- Return assignment procedures do not afford tax auditors the opportunity to gain experience in examining returns containing international issues or the time to prepare for examinations before scheduled interviews with taxpayers.

Comment:

Guidelines had been established in Manhattan to assign these cases to tax audit groups and to specific tax auditors as precontact analysis cases. This was to provide the opportunity for specific auditors to gain experience in examining these returns. Some returns selected for examination may require examination planning or may contain issues which require research or analysis prior to contacting the taxpayer. Returns in this category are identified for precontact analysis. These procedures were not being followed; however, it was corrected immediately when brought to the Branch Chief's attention during an IRS visit to Manhattan.

PAGE 5, PARAGRAPH 1

-- The Foreign Operations District does not summarize the examination work it carried out before transferring a return to a domestic district office and does not highlight the name and telephone number of the tax auditor who initiated the examination. As a result, prior work may be duplicated and examination progress may be slowed.

BEST DOCUMENT AVAILABLE

Comment:

This was not so revealed during the IRS review. Fifty-two cases were reviewed, looking at the same items as GAO. Every case contained a tax auditor's name and telephone number in the Foreign Operations District (FOD). In some cases the FOD tax auditors had prepared instructions to the receiving auditor on how to follow through with the adjustment.

PAGE 6, PARAGRAPH 4

Thus, domestic district tax auditors face a difficult task in carrying out examinations of tax returns containing international issues. And, our discussions with Manhattan District tax auditors indicate that taxpayers and/or tax practitioners may be well aware of the difficulty of that task. In this regard, several Manhattan District tax auditors expressed the concern that taxpayers may request transfers in hopes of getting more favorable examination results from domestic districts than might be available from the Foreign Operations District. Our analysis of examination cases transferred to the Manhattan District lends some possible credence to that theory.

Comment:

During our review and discussions with Manhattan tax auditors, we did not come to the same conclusion. Each case file reviewed contained a taxpayer letter citing specific reasons for the transfer of his/her return. Our sample of returns did not indicate that taxpayers were receiving more favorable examination results.

PAGE 7, PARAGRAPHS 1 and 2

....Specifically, in 9 cases, the Foreign Operations District had corresponded with the taxpayers and gone as far as proposing tax adjustments in examination reports. In 6 of the 9 cases, the Foreign Operations District had also received supplemental information from the taxpayer and had written a second examination report. Still the affected taxpayers, after receiving Foreign Operations District reports, had requested transfer of their examinations to the Manhattan District Office.

Neither we nor IRS know why these taxpayers were so motivated. They may simply have wanted the opportunity to discuss the return at issue with IRS on a face-to-face basis. Nonetheless, the fact that the transfers were requested subsequent to receipt of proposed tax adjustments, rather than at the outset of the examination process, lends some credence to the possibility that the taxpayers may have been seeking more favorable results.

BEST DOCUMENT AVAILABLE

Comment:

An examination report is prepared for the taxpayer proposing adjustments and reflecting the tax deficiency and/or tax refund resulting from those proposed adjustments. Frequently, in tax auditor cases, the taxpayer will present new information after receipt of the initial report; then, the report is voided, and a new report is prepared. If a correspondence examination has been conducted, it is not unusual for a taxpayer to request a transfer after a report is issued so that the proposed adjustments can be discussed face to face. In both instances, regardless of the issue, the matter may be resolved although we feel this is due to the additional information obtained rather than inadequate handling of the case. The Service's objective as stated in Policy Statement P-4-40 is to dispose of tax differences at the lowest level without sacrificing the quality or integrity of the examination. Thus, every attempt is made to resolve cases through transfers and face-to-face discussions with the taxpayer.

PAGE 10, PARAGRAPH 1

....However, Foreign Operations District tax auditors do not always summarize the work they have performed before sending returns to domestic districts. Moreover, they do not always specifically identify themselves as contact points for resolving questions domestic district tax auditors may have about work performed before the return was transferred.

Comment:

Our review of cases did not reflect these findings - "lack of summaries." In fact, many of the cases contained information for the new auditor on how to follow through with the adjustments if the taxpayer cannot verify information on the return, along with a telephone number.

PAGE 10, PARAGRAPH 2

....Furthermore, the guidelines do not require that group managers ensure that a summary has been prepared before approving a transfer.

Comment:

Form 3185 (Transfer of Return) contains an approval block for a group manager and other. This does not mean that by approving this form the case file is in order. We agree that group managers in approving these transfers should review the case file for completeness, including summaries. However, some transfers are initiated prior to any examination work; therefore, no summary would be required. Each case we reviewed was approved by a group manager and did contain summaries.

BEST DOCUMENT AVAILABLE

PAGE 10, PARAGRAPH 3

Because Foreign Operations District tax auditors do not prepare summaries, domestic district tax auditors must review all the paperwork included in each case file to determine the status of an examination.

Comment:

Our case review did not reflect the GAO findings. All cases we reviewed did contain in one form or another summaries of actions taken.

BEST DOCUMENT AVAILABLE

Enclosure II

IRS COMMENTS ON GAO DRAFT REPORT "SPECIAL PROCEDURES WOULD IMPROVE IRS EXAMINATIONS OF CERTAIN RETURNS CONTAINING INTERNATIONAL TAX ISSUES"

Comments on Recommendations

A. RECOMMENDATION

-- Provide a limited number of tax auditors in selected domestic district offices with training in international tax issues. This should be done in those district offices which have a case workload sufficient to justify expenditures on such training. An alternative would involve considering the feasibility, from a cost-benefit standpoint, of detailing Foreign Operations District tax auditors to certain domestic districts for the purpose of conducting or completing examinations of returns transferred by the Foreign Operations District. For example, affected domestic districts could accumulate these returns for a period of time until a sufficient caseload inventory developed. Then, the Foreign Operations District could detail a tax auditor to the domestic district to work the cases. The latter approach was suggested as a possibility by IRS officials during our February 1982 meeting.

Comment:

We concur with providing training to a limited number of tax auditors in selected domestic districts. In July 1982, a task force will convene to prepare the materials for the training course. It is expected that this course will be given in the first quarter of FY 83.

B. RECOMMENDATION

-- Provide each IRS domestic district office with Foreign Operations District training manuals and other appropriate reference documents for use by tax auditors conducting examinations of returns containing international issues.

Comment:

We concur with providing necessary reference materials to the limited number of tax auditors who are provided the special training.

BEST DOCUMENT AVAILABLE

C. RECOMMENDATION

-- Revise return assignment procedures to provide tax auditors the experience and preparation time needed to examine returns transferred by the Foreign Operations District. Specifically, returns should be assigned to selected tax auditors designated to examine returns containing international issues. Also, returns should be assigned in advance of scheduled taxpayer interviews to allow tax auditors the time to research issues and to review examination work already performed.

Comment:

We do not concur with revising return assignment procedures as covered in the Internal Revenue Manual. However, a memorandum will be sent to the regions receiving FOD cases to emphasize precontact analysis for these returns. This would permit the tax auditors time to research and to analyze cases before scheduling appointments. The Service will also advise the district offices to assign these cases to tax auditors with experience in examining foreign issues.

D. RECOMMENDATION

-- Require that the Foreign Operations District develop and make effective use of standard summary information reports for returns transferred to domestic district offices. The reports should clearly explain the international tax issues involved, the work done, and the conclusions reached, and should describe any special circumstances concerning the transferred return. Also, the summary report should contain the name and telephone number of an appropriate Foreign Operations District contact. Finally, the Commissioner should require that Foreign Operations District group managers ensure that case files contain summaries before the files are transferred to domestic district offices.

Comment:

We do not concur. The subsequent review by IRS concluded that standard summaries were being used, and group managers were ensuring that case files contained summaries.

(268137)